



STATE OF WISCONSIN
Department of Employee Trust Funds
Eric O. Stanchfield
SECRETARY

801 W Badger Road
PO Box 7931
Madison WI 53707-7931

1-877-533-5020 (toll free)
Fax (608) 267-4549
TTY (608) 267-0676
<http://etf.wi.gov>

CORRESPONDENCE MEMORANDUM

DATE: September 27, 2004
TO: Wisconsin Deferred Compensation Board
FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program
SUBJECT: T. Rowe Price International Stock Fund Recommendation

The Wisconsin Deferred Compensation (WDC) Investment Committee met on August 19, 2004, to review the performance of T. Rowe Price International Stock Fund (T. Rowe Price). As a result of their review, the Investment Committee determined that T. Rowe Price is no longer desirable as an investment option to be offered to WDC participants.

After reviewing replacement international funds and evaluating their suitability for the WDC, the Investment Committee is making the following recommendation to the WDC Board for their consideration and action:

- Initiate the removal of T. Rowe Price from the WDC core spectrum, following established fund phase-out procedures; and
- Add the EuroPacific Growth Fund (Class R5) to the WDC core spectrum as the WDC's international fund offering.

Background

The T. Rowe Price International Stock Fund is one of the WDC's options for participants seeking exposure to the foreign stock market. As of June 30, 2004, there were 14,234 WDC participant accounts in this fund.

During the 2003 annual investment performance review on May 12, 2004, the Board concluded that T. Rowe Price was not meeting established benchmarks. The performance of T. Rowe Price failed to meet its performance benchmarks for the one and five-year periods, while its three and ten-year return exceeded one of the three benchmarks. As of December 31, 2003, the fund had been in the third quartile of its peer group for eight of the last nine quarters. The Board asked the Investment Committee to continue to monitor the performance of T. Rowe Price and to review other options for an international stock offering.

On August 19, 2004, the Investment Committee further reviewed the performance of T. Rowe Price. This performance review revealed that as of June 30, 2004, T. Rowe Price's performance fell below the Morgan Stanley Capital International, Inc. Europe, Australasia, and Far East (MSCI EAFE) Index for the past four calendar years and year-to-date in 2004. The fund under performed the Morningstar Foreign Stock Category prior to the implementation of the new classifications in mid 2003.

Reviewed and approved by Pam Henning, Office of Strategic Services

Signature _____

Date _____

T. Rowe Price is currently classified in the Foreign Large Growth Category. When compared with funds in the Morningstar Foreign Large Growth Category, the fund is in the 40th percentile for the three-year period and the 50th percentile for the five-year period. Performance for the one-year period is in the 59th percentile, indicating the fund's more recent performance lags relative to the peer group.

The Investment Committee agreed that removal of T. Rowe Price was warranted, noting that if T. Rowe Price is removed but not replaced, the WDC will not have any options for participants wishing to invest in the international category. The EAFE Equity Index Fund is available, but it is not heavily utilized. As of December 31, 2003, only 1,690 of 40,593 WDC participants (4%) had assets in the EAFE Equity Index Fund.

Summary of Fund Review Process and Selection Criteria

The universe of large cap international mutual funds was reviewed to determine which funds met the Board's established criteria for fund selection, which is as follows:

- Minimum five-year operating history – may be waived for index funds.
- Expense ratio not greater than mean for appropriate peer group.
- Five-year rolling average performance must equal or exceed appropriate benchmark or index.
- Minimum total asset size of \$400 million – may be waived for certain fund categories.
- Anticipated WDC assets not greater than 5% of total fund – determined by reviewing current WDC asset levels in a comparable fund.
- No loads or sales charges unless they are waived for the WDC.
- Not a sector fund.

Five funds remained for review after the screening criteria were applied to the universe of international funds. Following an initial evaluation of the funds, the Investment Committee requested additional information on two funds, the EuroPacific Growth Fund (Class R5) offered by American Funds and the Harbor International Fund (Institutional Class). The Investment Committee heard presentations from representatives of these funds at a meeting on September 21, 2004.

EuroPacific Growth Fund (Class R5)

EuroPacific Growth Fund (Class R5) is a foreign large blend or core fund offered by American Funds. It has low expenses of 0.61% and assets of \$33 billion. It has low portfolio turnover and utilizes the typical American Funds management structure of assembling several long-tenured managers as part of a team approach. Performance exceeds the MSCI EAFE Index for the three and five-year periods and the foreign large blend category average for the one, three and five-year periods. The fund also beats the MSCI World Ex-US Index for three of the past five calendar years. Emerging markets exposure is approximately 16%. There are no redemption fees currently anticipated by this fund.

Harbor International Fund (Institutional Class)

Harbor International Fund (Institutional Class) is a foreign large value fund that is actively managed by Hakan Castegren, the longest serving manager in the foreign large value group. Castegren and his team rely on a wide-ranging blue-chip value style. Emerging markets

exposure is listed as 13% of assets. The fund's expense ratio is 0.86% and assets are \$7 billion. Performance exceeds the MSCI World Ex-US Index and falls within the top half of the category for the three and five-year periods. Performance exceeds the index for seven of the past ten calendar years.

Recommendations

Investment Committee members and staff offer the following two recommendations to the Board for their consideration and action:

- Removal of the T. Rowe Price International Stock Fund from the WDC core spectrum, following the WDC's established fund phase-out process.

If the Board approves the Investment Committee's recommendation to remove T. Rowe Price, the established fund phase-out process should continue. The next phase would be to instruct participants to redirect current deferrals made to T. Rowe Price to alternative options beginning February 1, 2005, and to transfer any remaining account balances to alternative options by December 31, 2005.

- Replacement of the T. Rowe Price International Stock Fund with the EuroPacific Growth Fund (Class R5).

The Investment Committee recommends and staff concurs that the EuroPacific Growth Fund (Class R5) should be recommended to the Board for consideration. The Investment Committee made this recommendation because the EuroPacific Growth Fund is a large blend style fund (a combination of growth and value styles) and demonstrates more consistent performance over time vs. value or growth styles. The core investment strategy is preferred because it appears to be more stable. Value-only or growth-only strategies can be quite volatile during various cycles of the market.

In addition, the Investment Committee believes that the fund exhibits better diversification and that the fund benefits from the substantial research group available to the fund managers because they are part of the larger American Funds organization.

If the Board approves the Investment Committee's recommendation to replace the T. Rowe Price International Stock Fund with the EuroPacific Growth Fund (Class R5), staff will work with the plan administrator to add this fund to the WDC offerings. The target date for opening the fund to WDC participants will be sometime during the spring of 2005.